No. 77-920

In the Supreme Court of the United States

OCTOBER TERM, 1978

THOR POWER TOOL COMPANY, PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A-6 to A-32) are reported at 64 T.C. 154. The opinion of the court of appeals (Pet. App. A-34 to A-48) is reported at 563 F.2d 861.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1977 (Pet. App. A-33). The petition for a writ of certiorari was filed on December 27, 1977, and was granted on March 6, 1978 (A. 267).

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The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Petitioner reduced its closing inventory to an estimated "net realizable value," thereby increasing its cost of goods sold and reducing its taxable income by the amount of the inventory "write-down."

The questions presented are:

a. Whether petitioner's inventory write-down most clearly reflected its income under Section 471 of the Internal Revenue Code of 1954 and met the requirements of the controlling Treasury Regulations.

b. Whether petitioner's inventory write-down constituted a change of accounting method requiring the prior consent of the Commissioner under Section 446(e) of the Code.

2. Whether the Commissioner properly exercised his discretion under Section 166(c) of the Code in determining the reasonable addition to petitioner's bad debt reserve on the basis of its prior experience with respect to the collection of accounts receivable, rather than on the basis of its estimates of collectibility.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 446, and 471 of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulations on Income Tax, Sections 1.166-4, 1.446-1, 1.471-1, 1.471-2, and 1.471-4 (26 C.F.R.,) are set forth in the Appendix, *infra*, pp. 77-78.

STATEMENT

1. *Inventory write-down issue.* a. Petitioner is a manufacturer of tools, parts and accessories, and of various rubber articles. During 1964, the year in question, petitioner conducted its business at three plants in its Tool Division and at a fourth plant in its Rubber Division. Petitioner's three Tool Division plants maintained inventories of raw materials work-in-process, finished parts, and accessories. Its single Rubber Division plant maintained inventories of raw materials, work-in-process and completed products. Petitioner's 24 sales and service branches likewise maintained inventories of spare parts and accessories for each tool petitioner manufactured, as well as the complete tools. Petitioned employed the "lower of cost or market" method of valuing its inventory for both financial reporting and federal income tax purposes (Pet. App. A-8 to A-9, A-35).

When petitioner terminated the manufacture particular tools or models, it continued to stock replacement parts and accessories for those tools still in service. In 1960, petitioner established an inventory contra account entitled "Reserve for Inventory Valuation" (RIV) for the purpose of reducing the value of its closing inventory of replacement parts and accessories for discontinued tools. Petitioner thereafter began to amortize, over a ten-year period, the cost of its inventories of such items that were attributable to out-of-

production tools. Accordingly, petitioner credited its RIV account with ten percent of the cost of a part or accessory beginning with the year that it terminated production of the associated tool.[1] Petitioner subtracted these amounts from its closing inventory, thereby increasing its cost of goods sold and reducing its taxable income by corresponding amounts. Petitioner continued to reduce its closing inventories in accordance with this practice in both its financial statements and income tax returns for 1961, 1962, 1963, and through the first three quarters of 1964 (Pet. App. A-9 to A-10, A-35 to A-36).[2] Prior to its 1964 return, petitioner did not disclose either the existence of the inventory reserve account or its use in reducing its closing inventory and taxable income (Stip. of Facts, ¶¶ 2, 3, A. 23, 24).[3]

[1] Accordingly, on December 31, 1960, petitioner credited the RIV account with $116,244.52, reflecting a 100 percent write-off of parts and accessories for tools that it discontinued during and prior to 1950; a 90 percent write-down of parts and accessories for tools discontinued in 1951; and corresponding partial write-downs for parts and accessories for tools that were discontinued in subsequent years, ending with a 10 percent write-down of parts and accessories for tools discontinued in 1959 (Pet. App. A-9; Stip. of Facts, ¶6, A. 24).

[2] During 1960-1963, petitioner credited an aggregate of $152,117 to the inventory reserve and subtracted that amount from closing inventories. It credited an additional $22,090 to the reserve during the first three quarters of 1964, the year in issue (Pet. App. A-9 to A-10, A-35 to A-36; Stip. of Facts, ¶6, A. 24).

[3] Beginning in 1962, the corporate income tax return (Form 1120) contained a series of questions concerning inventory. The second question asked the taxpayer whether it made write-downs to inventory. "This question was unanswered in petitioner's 1962 and 1963 returns, but was answered in petitioner's 1964 return" (Stip. of Facts, ¶3). In its 1964 return, petitioner answered the question affirmatively and attached a schedule (Ex. 7-G, A. 226) disclosing the write-downs. Petitioner further stated in answer to the question on the return that its inventories "[were] stated on the same basis and were determined generally in the same manner as inventories at December 31, 1963 except that as a result of revision in operating policies made late in 1964, revised procedures were adopted to value excess stock" (*ibid.*).

In December 1964, new management assumed control of petitioner.[4] As part of their preparation of the 1964 financial statements, the new officers undertook "a complete re-evaluation of the assets and liabilities of the company," including "a physical inventory * * * at all locations" of the Tool and Rubber Divisions (A. 51, 52). The new management concluded that petitioner's existing quantities were in excess of anticipated market demand and that prior management had overstated inventory by reflecting it at full value. Accordingly, in preparing the 1964 financial statements, the new management adjusted petitioner's inventory to its "net realizable value," in accordance with accounting standards (Pet. App. A-10, A-36). In its 1964 annual report to its shareholders, petitioner characterized the extraordinary charge produced by the new inventory valuation procedures as resulting from "changes in accounting practices and principles" (Ex. P, A. 227).

[4] A proposed merger of petitioner into Stewart-Warner Corporation was abandoned in early December 1964, apparently because an investigation and audit convinced Stewart-Warner that petitioner's assets were overstated. The purchase agreement between the two companies was mutually rescinded at that time, and Stewart-Warner agreed to provide management assistance to petitioner. Accordingly, a Stewart-Warner employee assumed the presidency of petitioner on December 14, 1964 (Pet. App. A-10, A-36 n. 4; A. 50, 68).

Petitioner further explained that "[c]hanges were made in the methods of determining and valuing obsolete and excess inventory" (Ex. P, A. 232). However, in their report appended to its 1964 annual statement, petitioner's independent auditors cautioned that "[w]hile we believe the new [accounting] procedures to be reasonable in the circumstances, their appropriateness, particularly as they relate to inventory valuation, can only be adequately evaluated in the light of future events" (Ex. P, A. 233).[5]

In making the adjustments to its inventory accounts, petitioner considered obsolete all spare parts of tools that had never been offered for sale during 1964 or for which there had been no demand during 1964. This assumption resulted in an inventory write-down of approximately $2,750,000. The Commissioner did not challenge this write-down because petitioner scrapped the items in question soon after they were removed from its 1964 closing inventory. Petitioner also wrote off $245,000 of inventory reflecting parts stocked for three unsuccessful products (A. 56). The Commissioner did not question this second inventory write-down because petitioner sold the products at reduced prices soon after the write-down (Pet. App. A-36) (see also Ex. Q, A. 242).

b. Petitioner wrote down its remaining inventory, consisting of approximately 44,000 items, according

[5] The accountants' opinion was admitted into evidence to show that petitioner's 1964 annual report contained such an opinion but not for the purpose of proving the truth or the correctness of the matters discussed in it (A. 43, 233).

to its estimates of future demand. It is the write-down of these remaining items (considered by petitioner to be excess inventory) that is principally at issue in this case. With respect to the inventory at two of its Tool Division plants, petitioner's estimates were based upon 1964 sales figures and resulted in inventory write-downs of $744,030.[6] As petitioner's president explained, the 1964 sales figures were used as a basis because the company had no budget or forecast for the ensuing year (A. 57). However, because of the inadequacy of the sales data at the other two plants, petitioner reduced the value of the inventories of raw materials, work-in-process, and finished products by flat percentage adjustments. These adjustments resulted in inventory write-downs of $160,832 (Pet. App. A-10 to A-12, A-36 to A-37).[7]

[6] Petitioner reduced its gross usable inventory at these plants as follows (Pet. App. A-11, A-37 n. 6; Stip. of Facts, ¶9, A. 25-26):

"(1) Items not in excess of 12 months' anticipated demand were not written down.

"(2) Items in excess of 12 months' anticipated demand, but not in excess of 18 months' anticipated demand were written down 50 percent.

"(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

"(4) Items in excess of 24 months' anticipated demand were written off completely."

[7] Petitioner's flat percentage reductions in inventory valuation were as follows: (1) five percent for tool parts and motor parts at its LaGrange Park plant; (2) ten percent for raw materials, manuals and name plates, and work-in-process at LaGrange Park; (3) 50 percent for hardware at LaGrange Park; and (4) ten percent for raw materials, work-in-process, and finished goods at its Cincinnati plant (Pet. App. A-12, A-37 n. 7).

Since late 1964, petitioner has not attempted to sell at reduced prices any of the parts it estimated to be excess inventory. To the contrary, it continued to offer and sell them at their original prices. The market for such parts was confined to owners of the related tools who purchased replacement parts only when they needed them. However, the owners of related tools would not buy spare parts that they did not need simply because of price reductions (Pet. App. A–14, A–42 to A–43; A. 62). As petitioner's president conceded, petitioner "made no effort [to sell what it considered to be excess spare parts] except through the normal channels—normal prices to sell the service parts inventory" (A. 61). The same was the case for the raw materials, the finished tools and the work-in-process (A. 62–63). In its 1965 annual report to its shareholders, petitioner stated that "[t]he 1964 special charge consisted primarily of write-downs for obsolete and excess inventories which could not be allocated to specific periods because adequate information is not now available" (Ex. Q, A. 236). As in the case of the 1964 report, petitioner's independent auditors cautioned that "[w]hile the [inventory] reserves provided reflect the best current judgment of the company's management, it is not possible to evaluate these reserves prior to the ultimate disposition of the inventories involved" (Ex. Q, A. 243).[8]

Petitioner credited the total of these inventory write-downs to its inventory reserve contra account. The increase to this account reflected: (1) the $22,090 amortization that the prior management had claimed for the first three quarters of 1964; (2) the $744,030 write-down based upon petitioner's estimates of anticipated demand; and (3) the $160,832 write-down arising from flat percentage reductions. As of December 31, 1964, these write-downs increased petitioner's inventory reserve account by a total of $926,952, and resulted in a corresponding reduction of its closing inventory for 1964 for purposes of its 1964 financial statement and its income tax return. The reduction in closing inventory increased petitioner's cost of goods sold and thereby reduced its 1964 taxable income by $926,952 (Pet. App. A–12 to A–14, A–36 to A–37; A. 61).[9]

On audit, the Commissioner of Internal Revenue disallowed petitioner's three claimed reductions in the value of its inventory totalling $926,952 on the ground that they did not clearly reflect its 1964 income for tax purposes (Pet. App. A–37).[10] By amendment to his answer, the Commissioner advanced two additional

[8] The accountant's opinion was admitted into evidence for the limited purpose of showing that petitioner's 1965 annual report contained such a caveat. See p. 6 n. 5, *supra*.

[9] Although petitioner's inventory write-downs at issue were for 1964, the Commissioner's disallowance resulted in a deficiency for 1963 because of a claimed net operating loss carryback under Section 172 (see A. 5–6).

[10] The Commissioner's notice of deficiency originally disallowed $1,079,069, the total credit balance in petitioner's inventory contra account at the end of 1964 (A. 3). However, the net addition to that account and equivalent reduction in petitioner's closing inventory and taxable income for 1964 was $926,952. Accordingly, the Commissioner conceded before the Tax Court that only the credits totalling $926,952 were at issue. He did not, however, concede the correctness of petitioner's method of computing the 1964 opening balance of $152,117 in the inventory contra account (Pet. App. A–37 to A–38 n. 8).

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grounds for his disallowance of the inventory write-downs. First, that petitioner failed to value its opening inventory for 1964 in accordance with the method used to value its closing inventory. Second, that petitioner's new inventory valuation procedures constituted a change in its method of accounting, requiring the prior permission of the Commissioner under Section 446(e) of the Code (A. 20). Petitioner admitted that it did not obtain the Commissioner's consent to use its new inventory valuation procedures (A. 22).[11]

c. Petitioner sought review of the Commissioner's determination in the Tax Court. As the Tax Court noted, petitioner did not challenge the validity of the applicable Treasury Regulations promulgated under Sections 446 and 471. Instead, petitioner contended that its inventory valuation procedures complied with the Regulations. The Tax Court held that petitioner's write-down of excess inventory was not permitted by the Regulations. It therefore concluded that petitioner's claimed adjustments did not clearly reflect its income for 1964 and the Commissioner did not abuse his discretion by reducing petitioner's cost of goods sold and restoring that amount to income (Pet. App. A-30).

As the Tax Court pointed out, Section 1.471-4(a) of the Regulations had long been held to require that a taxpayer employing the lower of cost or market inventory method compute "market" value on the

[11] Pursuant to petitioner's motion (A. 14-18), the Tax Court had previously ordered that the Commissioner would bear the burden of proof if he put in issue the change of accounting method question (A. 19).

basis of replacement or reproduction cost rather than "net realizable value" (Pet. App. A-23 to A-24). Moreover, the Tax Court rejected petitioner's claim that its excess inventory was an extraordinary circumstance that justified its write-down to net realizable value on the basis of petitioner's estimates as to its ultimate salability. To the contrary, the court concluded that "the acquisition or production of such slow-moving units was a recurring, ordinary, and necessary incident of manufacturing, marketing, and maintaining petitioner's products" (Pet. App. A-26).

Finally, the Tax Court held that petitioner's excess inventory was not analogous to damaged or imperfect items that Section 1.471-2 of the Regulations permits to be valued at bona fide sale prices less the cost of disposition. The court pointed out that at all events petitioner had not offered these items for sale at reduced prices (Pet. App. A-27 to A-28).[12] Accordingly, the Tax Court entered a decision finding a deficiency in petitioner's 1963 tax liability of $494,055.99 (A. 264).

The court of appeals affirmed (Pet. App. A-34 to A-48). It upheld the Tax Court's conclusion that

[12] The Tax Court did not reach the Commissioner's alternative arguments that: (1) petitioner's new inventory valuation procedure constituted a change in its method of accounting requiring the prior consent of the Commissioner under Section 446(e); and (2) that petitioner's inventory accounting did not clearly reflect its income because it did not employ consistent assumptions insofar as it failed to revalue its 1964 opening inventory in accordance with the methods used to value its closing inventory for that year (Pet. App. A-41 n. 12).

petitioner's inventory write-downs were not permitted by the applicable Treasury Regulations and that the Commissioner did not abuse his discretion under Sections 446 and 471 in determining that inventory that was not yet scrapped or otherwise shown to be without value by objective evidence could not be written off for tax purposes (Pet. App. A-41 to A-42).

In so holding, the court rejected petitioner's claim that its excess inventory was an exceptional circumstance that permitted market valuation under the lower of cost or market method to be set at other than replacement cost. See Treasury Regulations, Section 1.471-4 (26 C.F.R.) (Pet. App. A-43 to A-44). As the court observed, petitioner's "own chief executive officer stated that 'any business which is involved in the manufacture and sale of products inevitably must have excess inventory,' that this was particularly true in 'the kind of business that Thor was in * * * which involves a very high percentage of service parts and accessories,' and that many manufacturing costs are 'independent of quantity'" (Pet. App. A-43 to A-44; A. 54, 55).

Moreover, the court of appeals agreed with the Tax Court's determination that petitioner did not meet its burden of proving that its excess inventory was "unsalable at normal prices * * * because of damage, imperfection, shop wear, changes of style, odd or broken lots, or other similar causes * * *" within the meaning of Section 1.471-2(c) of the Regulations. The court further upheld the Tax Court's conclusion that this section of the Regulations was inapplicable because petitioner had not offered the items for sale at reduced prices (Pet. App. A-42 to A-43).

Finally, the court held that the fact that petitioner's inventory valuation procedures conformed to the best accounting practice did not control the question of the proper federal tax treatment of petitioner's inventory accounts. As the court noted, the Commissioner's broad discretion under Section 471 to regulate the use of inventory accounting rests upon a two-part test. The taxpayer's inventory method must conform to the best accounting practice in the particular trade or business and most clearly reflect its income (Pet. App. A-39). In the court of appeals' view, petitioner's inventory write-downs did not clearly reflect its income because the new method of valuation at "net realizable value" was not consistent with petitioner's prior method of inventory accounting (Pet. App. A-45).

Specifically, the court referred to the fact that although petitioner's excess inventory had been accumulated over a period of several years, "the new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years" (Pet. App. A-45). As the court observed, "* * * this large discrepancy was enough to indicate that consistency was lacking" (*ibid.*). The court therefore concluded that petitioner failed to meet the requirement of Section 1.471-2(b) of the Regulations that "[i]n order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year * * *." Since petitioner's expert accountants did not testify that its

1964 income had been clearly reflected in its tax return or that its method of accounting was necessary in order to state its 1964 income, the court of appeals held that petitioner had not met its burden of proving that the Commissioner had abused his discretion in restoring the inventory write-downs to income (Pet. App. A-45 to A-46).

2. *Addition to bad debt reserve issue.* Petitioner employed the reserve method for deducting bad debts authorized by Section 166(c) of the Code. At the close of 1965, petitioner's new management estimated the collectibility of its accounts receivable. In the Tool Division, petitioner evaluated each 90-day-old account in excess of $100 and established a 100 percent reserve for the account in that category that is considered to be wholly uncollectible. Petitioner thereupon applied the dollar ratio of uncollectible accounts to total 90-day accounts exceeding $100 to its 90-day-old accounts that were less than $100. The resulting figure constituted the bad debt reserve for these smaller accounts. For all other 90-day account and all accounts between 30 and 90 days past due, petitioner established a flat two percent reserve. Finally, petitioner established a one percent reserve for all accounts less than 30 days old and for all accounts in the Rubber Division that it did not consider to be wholly uncollectible. These computations resulted in a total addition to petitioner's bad debt reserve of $136,150 for 1965. Petitioner deducted this

addition to its reserve on its 1965 tax return (Pet. App. A-16 to A-17, A-47).

On audit, the Commissioner rejected petitioner's method of computing the allowable additions to its bad debt reserve. Pursuant to his authority under Section 166(c) to allow reasonable additions to a reserve for bad debts in accordance with his discretion, the Commissioner recomputed petitioner's bad debt reserve on the basis of petitioner's actual collection experience pursuant to the formula approved in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula measures the current addition to the bad debt reserve based upon the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). Accordingly, the Commissioner divided the total amount of accounts petitioner wrote off as worthless over the six-year period ending with the tax year in question ($940,413) by the total amount of year-end receivables for all six years ($30,063,802). The resulting percentage (3.12) was then applied to the 1965 year-end receivables ($4,927,967) to derive the allowable reserve as of that date ($154,146.80). Since petitioner's computations yielded a reserve of $228,947.60, the Commissioner disallowed the difference ($74,-790.80) as a deduction for bad debts (Pet. App. A-16 to A-17, A-48; A. 3).

The Tax Court held that petitioner failed to sustain its burden of showing that the Commissioner's deter-

mination was an abuse of discretion. As the court pointed out, petitioner did not show that conditions at the end of 1965 made it less likely that its accounts receivable would be collected than in prior years. Indeed, the court concluded that collectibility was probably more likely at the end of 1965 than in at least some of the prior years because of the new management. It therefore rejected petitioner's contention that the Commissioner abused his discretion in rejecting its estimates as to collectibility because he based his determination upon past collection experience rather than current data (Pet. App. A–31 to A–32).

The court of appeals affirmed (Pet. App. A–47 to A–48). It characterized the showing that a taxpayer must make to overturn the Commissioner's disallowance of additions to a bad debt reserve as a "'heavy burden,'" observing that "the issue thus presented 'is whether the Commissioner's view is reasonable'" and "[i]f it is, the inquiry is ended" (Pet. App. A–48). In the court's view, "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (*ibid.*).

SUMMARY OF ARGUMENT

I

A. Inventories are a device for computing the cost of goods sold and thereby measuring a given year's income within an annual accounting system. The cost of the opening inventory plus the cost of goods acquired during the year minus the cost of the closing

inventory will yield the cost of goods sold during the year. Any reduction of the closing inventory will therefore increase the cost of goods sold, and correspondingly reduce income for the year. The question presented is whether petitioner could properly, while retaining its stock of goods unreduced in amount or price, write down its closing inventory of spare parts associated with the tools it manufactured by $926,592 because it estimated that its inventory would prove to be in excess of demand for such parts in future years.

We submit that the decision below correctly upheld the Comissioner's disallowance of petitioner's claimed inventory write-down. As both the Tax Court and the court of appeals recognized, Section 471 and the Treasury Regulations promulgated thereunder explicitly prohibit inventory write-downs based upon unverifiable estimated losses that are anticipated to occur in future years. That statute, which gives the Commissioner broad authority for prescribing inventory methods of accounting that "most clearly reflect[] the income of the taxpayer," has its genesis in the Revenue Act of 1918, and it, as well as the controlling Regulations that were issued in 1922, have been carried forward without substantial change.

The Regulations provide the specific directions that required the Commissioner to disallow petitioner's claimed write-down of $926,952 in its closing inventory for 1964. On the other hand, they permitted petitioner to write down its inventory by $2,750,000 for goods that were obsolete and scrapped, and by an

additional $245,000, reflecting goods relating to unsuccessful products that were offered for sale at reduced prices. "[I]t is fundamental * * * that as 'contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes' and 'should not be overruled except for weighty reasons.'" *Bingler* v. *Johnson,* 394 U.S. 741, 749–750, quoting from *Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, 501. This rule of deference is particularly appropriate here since the Regulations in question were issued pursuant to the express statutory authority of Section 471, and constitute a longstanding administrative interpretation that has been in effect during successive reenactments of the statute. *Helvering* v. *Winmill,* 305 U.S. 79; *Lykes* v. *United States,* 343 U.S. 118. Thus, the detailed Regulations that govern this case squarely support the Commissioner's differentiated treatment of petitioner's claimed inventory write-downs.

B. Petitioner's inventory write-downs of items it continued to hold for sale at unreduced prices are barred by the controlling Treasury Regulations under Section 471. Petitioner premises its claim for accounting autonomy upon a universalized reading of a single sentence in Section 1.471–2 of the Regulations, which states that an inventory method that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly

reflecting the taxpayer's income. Petitioner assumes a sweeping and open-ended scope for this statement, and ignores the fact that the phrase "as a general rule" necessarily connotes exceptions. Moreover, petitioner's broad construction of this single sentence as a universal principle cannot stand in the face of the particularized provisions of Regulations, the validity of which it does not explicitly challenge.

Finally, petitioner overlooks the fact that the same paragraph of the Regulations provides that "greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation * * *." But the Tax Court found and the court of appeals agreed that petitioner valued its opening inventory on a different basis from that of its closing inventory for that year. Thus, the decision can be affirmed on this independent ground.

Whatever weight might be given to the sentence relied upon by petitioner if it stood alone, it cannot modify the explicit provisions of paragraph (f) of the same Section 1.471–2, which sets forth five methods of valuing inventories that are disapproved for federal income tax purposes. The first three of these five, which overlap to some extent, describe in whole or in part the methods by which petitioner wrote down its inventories by $926,952, *ie.,* (1) deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof; (2) taking parts of the inventory at a nominal price, or at less than proper value; (3) omitting portions of the stock on hand. These provisions required the Commissioner's disallowance of petitioner's write-downs.

Nor does Section 1.471–2(c) of the Regulations support petitioner's claimed write-down. That provision permits an inventory reduction to bona fide selling price less direct cost of disposition for goods suffering from damage, imperfections, or other similar causes. But the courts below correctly held this provision inapplicable because petitioner's inventory deemed excess was not physically differentiated from the remainder of its inventory. At all events, Section 1.471–2(c) is inapplicable because, as the court of appeals also pointed out, it authorizes a write-down only if goods in question are sold or offered for sale at reduced prices within 30 days of the inventory date. Petitioner acknowledges that it failed to meet this requirement of the Regulations because it continued to hold its inventory for sale at unreduced prices.

Petitioner's reliance upon Section 1.471–4 of the Regulations, dealing with the valuation of inventories at the lower of cost or market, is similarly misplaced. As that Section of the Regulations makes clear, the term "market" refers to replacement cost, and not to the figure at which the taxpayer might sell its goods. Thus, even on the assumption that petitioner's estimate otherwise would require acceptance, its attempt to justify its reduction of inventory to "net realizable value" squarely conflicts with the Regulation's treatment of "market" as approved by numerous court decisions. Other provisions in the same section dealing with situations of restricted or inactive markets correlate inventory valuations with the taxpayer's proven sale prices at times before and after the inventory date. Since petitioner acknowledges its sale prices were unreduced, this section does not justify, but disapproves, its reduction in inventory values. Finally, Section 1.471–4 requires that where the inventory is valued at the lower of cost or market, each item of the inventory must be valued. Petitioner's use of an estimated value of the aggregate inventory is therefore explicitly disapproved by the Regulations.

C. Petitioner also seeks to justify its $926,952 write-down on the broader ground that it was consistent with generally accepted commercial accounting practices. While commercial accounting practices could hardly override the specific provisions of the controlling Regulations, the language of Section 471 establishes that the clear reflection of income standard is independent of commercial accounting considerations and that the Commissioner has wide latitude in determining whether a taxpayer's method of inventory accounting clearly reflects its income. As the introductory clause of the statute provides, the purpose of taking inventories is "in order clearly to determine the income of any taxpayer" and accounting rules are simply means to that dominant end. Thus, the question of conformity to "the best accounting practice in the trade or business" is not to be determined by the accounting profession but is to be resolved by "the opinion of the Secretary, on such basis as [he] may prescribe * * *," *i.e.,* the Regulations.

Moreover, an unbroken line of decisions of this Court confirms that generally accepted commercial ac-

counting practices do not govern the computation of federal income tax liability. See, *e.g.*, ***American Automobile Assn.*** v. ***United States,*** 367 U.S. 687; ***Schlude*** v. ***Commissioner,*** 372 U.S. 128; ***United States*** v. ***Catto,*** 384 U.S. 102. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives. Accordingly, the Court has consistently rejected attempts by taxpayers to reduce their taxable income by the use of reserves in anticipation of future losses. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions" (footnote omitted). *Lucas* v. *American Code Co.,* 280 U.S. 445, 452; *Brown* v. *Helvering,* 291 U.S. 193, 202.

Here, too, petitioner's accountants may have properly concluded that its $926,952 write-down of purportedly excess inventory was required in order to project a fair and conservative statement of its financial condition. But petitioner sustained no identifiable loss in the year of the write-down either by scrapping the items in question or offering them for sale at reduced values. To the contrary, petitioner continued to hold them for sale at their original prices. It therefore took no steps to confirm the accuracy of its estimated loss as required by the Regulations. Thus, petitioner's inventory write-down is nothing more than

a reserve to cover a contingency for an anticipated loss that may arise in the future. It cannot be taken into account in computing its current income.

D. Even if petitioner's reduction in its 1964 closing inventory were otherwise permitted under Section 471 and the controlling Treasury Regulations, its adoption constituted a change in accounting method which required the prior consent of the Commissioner under Section 446(e) of the Code. It is undisputed that petitioner did not seek and that the Commissioner did not give such consent (A. 22). Although neither the Tax Court nor the court of appeals reached this question (Pet. App. A-30, A-41 n. 12), the decision below that the Commissioner did not abuse his discretion in disallowing petitioner's adjustment to its 1964 closing inventory can be affirmed on this independent ground alone. See, *e.g.*, ***Dandridge*** v. ***Williams,*** 397 U.S. 471, 475-476 n. 6; ***LeTulle*** v. ***Scofield,*** 308 U.S. 415; ***Langnes*** v. ***Green,*** 282 U.S. 531.

II

The court of appeals also correctly held that the Commissioner did not abuse his discretion in rejecting petitioner's method of computing its bad debt reserve. Section 166(a) of the Code permits a taxpayer to claim a deduction for specific debts as they become worthless. Section 166(c) provides that, in lieu of the specific write-off method authorized by Section 166(a), "there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts." A

reasonable addition to a bad debt reserve is the amount necessary to bring the balance in the reserve account to a level that can be reasonably expected to cover the losses anticipated with respect to debts outstanding at the end of the year. *Dixie Furniture Co.* v. *Commissioner,* 390 F. 2d 139 (C.A. 8).

At the close of 1965, petitioner estimated the collectibility of each of its accounts. It set aside a 100 percent reserve for specific accounts it considered to be wholly uncollectible. It also applied the dollar ratio of uncollectible accounts to the total amount of accounts of more than $100 and applied this fraction to 90-day-old accounts with a balance of under $100. Moreover, it established a flat two percent reserve for all other 90-day accounts and all accounts between 30 and 90 days past due. Finally, petitioner established a one percent reserve for all accounts less than 30 days old (Pet. App. A-47). These computations resulted in a total addition to petitioner's bad debt reserve of $135,150 (Pet. App. A-48).

Pursuant to his authority under Section 166(c), the Commissioner recomputed petitioner's bad debt reserve by applying the formula approved in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula, which the courts have consistently approved as a "reasonable" method of computing a reserve for bad debts, measures the current addition to the bad debt reserve based upon the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). The *Black Motor* formula yielded an addition to petitioner's bad debt reserve of $74,790.80 (Pet. App. A-48).

As the court of appeals properly observed, Section 166(c) gives the Commissioner broad discretion to determine the reasonableness of any addition by a taxpayer to a bad debt reserve. In order to overturn the Commissioner's determination, the taxpayer must show an abuse of that discretion. *Calavo, Inc.* v. *Commissioner,* 304 F. 2d 650, 653-655 (C.A. 9); *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner,* 317 F. 2d 829, 834 (C.A. 7); *Akron National Bank & Trust Co.* v. *United States,* 510 F. 2d 1157 (C.A. 6); *Merchants Industrial Bank* v. *Commissioner,* 475 F. 2d 1063 (C.A. 10); *Paramount Finance Co.* v. *United States,* 304 F. 2d 460 (Ct. Cl.). Petitioner has not done so.

Rhode Island Hospital Trust Co. v. *Commissioner,* 29 F. 2d 339 (C.A. 1), *Calavo, Inc.* v. *Commissioner, supra,* or *Travis* v. *Commissioner,* 406 F. 2d 987 (C.A. 6), are not to the contrary. In each of those cases, the courts reaffirmed the Commissioner's statutory discretion with respect to bad debt reserves. However, the taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve was an abuse of discretion. Here, on the other hand, petitioner failed to make that showing. The court of appeals correctly concluded that "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (Pet App. A-48).

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ARGUMENT

I

PETITIONER'S REDUCTION OF ITS CLOSING INVENTORY TO AN ESTIMATED NET REALIZABLE VALUE DID NOT CLEARLY REFLECT ITS INCOME UNDER SECTION 471 OF THE CODE BECAUSE THE CONTROLLING TREASURY REGULATIONS PROHIBIT THE CURRENT DEDUCTION OF ESTIMATED FUTURE LOSSES

A. INTRODUCTION

The principal question presented in this federal income tax case is whether petitioner's method of valuing its inventory clearly reflected its income within the meaning of Section 471 of the Internal Revenue Code of 1954 (26 U.S.C.) and the controlling Treasury Regulations.[13] Section 471 is the current version of a long line of similar provisions since the Revenue Act of 1918, 40 Stat. 1057 that have accorded to the Commissioner of Internal Revenue the determination whether the use of inventories is necessary in order to clearly determine the income of any taxpayer. If the Commissioner determines that inventories are necessary, the statute requires that "inventories shall be taken by such taxpayer on such basis as the [Commissioner] may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Inventories are a well-established accounting device for computing the cost of goods sold. See *Rouss* v. *Bowers,* 30 F. 2d 628, 629 (C.A. 2), certiorari denied, 279 U.S. 853; 2 Mertens, *Law of Federal Income*

[13] Both the *amicus* brief filed by the National Association of Manufacturers (p. 4) in support of the petition and petitioner's reply to the government's brief in opposition urged that the question presented was of substantial administrative importance. Thus, petitioner's reply stated that "there are 371 cases docketed in the Tax Court and an unknown number pending in Federal District Courts involving the valuation of excess inventory. There are an additional 493 cases pending in the Appellate Division [of the Internal Revenue Service] and an estimated several times that number in the Audit Division of the Internal Revenue Service, a substantial number of which inevitably will find their way into the courts" (p. 1).

While the number of pending cases within the Audit Division cannot be readily ascertained, the Internal Revenue Service "Reports and Information Retrieval Activity" (RIRA) discloses that the figures cited by petitioner are somewhat misleading. The RIRA list of pending Tax Court cases included 380 cases presenting a "lower of cost or market" inventory issue. But of those 380 cases, 374 represented a single case involving a chain of department stores, each of which was separately incorporated and required a separate petition and docket number (see Belk-Leggett Department Stores, Nos. 11027–75 through 11400–75). The issue was whether certain inventory items belong in various "retail markup" categories under the retail method of inventorying, which is authorized for use only by retail merchandisers under Treasury Regulations, Section 1.471–8. The Service has advised us that this case (or 374 cases) will be settled without trial.

Of the other six pending Tax Court cases, two involve the valuation of excess inventory. Venue for one (*Altec Corporation* v. *Commissioner*, P-H Memo T.C., para. 77,438, December 29, 1977) would lie in the Seventh Circuit. The other case is *Will-Burt Co.* v. *Commissioner*, T.C. Docket No. 1989–76. The remaining four cases are either not on point or are being settled. *Curtis Electric Lighting Co.* v. *Commissioner*, No. 1933–70; *Towel Towns of America* v. *Commissioner*, No. 3129–77; *Rockwell International* v. *Commissioner*, No. 3121–77; *Universal Sporting Goods, Inc.* v. *Commissioner*, No. 239–78. Finally, on March 24, 1978, a petition was filed in the Tax Court in an additional case that appears to involve the issue of excess inventory (*Sargent-Welch Scientific Co.* v. *Commissioner*, No. 3148–78).

Likewise, the RIRA report showing cases pending in the Appellate Division of the Service indicates that there are 382 cases

Taxation § 16.03 (1974 Rev.). The inventory method of accounting permits a taxpayer to compute his cost of goods sold without necessarily identifying those goods on an item-by-item basis. Even before the revenue acts contained any provisions with respect to methods of accounting, it was recognized that if a merchant bought a stock of goods in one year and sold them in the following year, his income would not be properly reflected for either year if he took a deduction for the cost of the goods in the first year and reported the entire selling price as income in the second year. As this Court recognized in *United States* v. *Catto*, 384 U.S. 102, 109, "[t]he general and long-standing rule for all taxpayers, whether they use the cash or accrual method of accounting, is that costs incurred in the acquisition, production, or development of capital assets, inventory, and other property used in the trade or business may not be currently deducted, but must be deferred until the year of sale, when the accumulated costs may be set off against the proceeds of the sale" (footnote omitted).

Accordingly, the early Treasury Regulations defined gross income from the sale of goods as the difference between the price received and the cost of goods sold and prescribed the use of inventories to compute the cost of goods sold.[14] The cost of goods sold may be determined by taking the cost of goods in the opening inventory, adding the costs of goods acquired during the year, together with any labor and material expenses, and subtracting the cost of goods in the closing inventory. See *Frank G. Wikstorm & Sons, Inc.* v. *Commissioner*, 20 T.C. 359, 361.

The mechanics of the computation of costs of goods sold can be illustrated by the following example of a taxpayer who buys old bicycles, rebuilds them with new parts, and sells them. At the beginning and end of its taxable year, it had inventories of $5,200 and $6,000, respectively. During the current taxable year, it paid $4,000 for old bicycles, $1,200 for labor in renovating them, and $1,000 for new parts. The computation of cost of goods sold and gross profit for the taxable year would be as follows:

pending in the same category, including the 374 cited above. Of the remaining eight cases listed, five do not involve the question presented here. (Four of those cases relate to the same taxpayers.) Two of the remaining cases involve related taxpayers and the taxpayers have conceded the issue presented here. In the last case, which is pending in Chicago, venue would lie in the Seventh Circuit. Since these cases are not reflected in any public record, Section 6103 of the Internal Revenue Code (26 U.S.C.) prohibits disclosure of the taxpayers' names.

To the extent that this Court may have granted certiorari on the assumption that the question presented was of public importance, the foregoing information indicates that the "special and important reasons" required by Rule 19 for discretionary review by this Court are lacking in this case. In these circumstances, the Court may wish to consider whether the writ of certiorari should be dismissed as improvidently granted. See *Rudolph* v. *United States*, 370 U.S. 269; *Rice* v. *Sioux City Cemetery*, 349 U.S. 70, 76–80, and 78 n. 2.

[14] See Treasury Regulations 31 (Excise Tax Act of August 5, 1909), Arts. 2(3) and (4), 5; Treasury Regulations 33 (Income Tax Act of 1913), Arts. 104, 105, 161; Treasury Regulations 33 (Revised) (Revenue Act of 1916), Arts. 91, 92, 120.

1. Gross receipts		$11,000
2. Opening inventory	5,200	
3. Merchandise bought	4,000	
4. Labor	1,200	
5. Supplies	1,000	
6. Total	11,400	
7. Closing inventory	(6,000)	
8. Cost of goods sold		5,400
9. Gross profit		5,600

It can be seen from the foregoing example that, if other factors are constant, a reduction in the closing inventory will result in a corresponding increase in cost of goods sold and a decrease in current income. The smaller the valuation accorded to closing inventory, the larger the ~~account~~ amount attributable to goods sold during the current year, the cost of which may be currently deducted and need not be deferred to a future period. As the Court pointed out in *Lucas* v. *Structural Steel Co.,* 281 U.S. 264, 268, "[t]he Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized. The purpose of the inventories is to assign to each period its profits and losses."

B. PETITIONER'S INVENTORY WRITE-DOWNS OF ITEMS IT CONTINUED TO HOLD FOR SALE AT UNREDUCED PRICES ARE BARRED BY THE CONTROLLING TREASURY REGULATIONS

1. In this case, petitioner's new management made three large-scale reductions to its closing 1964 inventory, thereby increasing its cost of goods sold for that year and reducing its taxable income. First, petitioner wrote down its closing inventory by $2,750,000 to reflect items that were thereafter scrapped because they were obsolete. Second, petitioner reduced its closing inventory by $245,000 to reflect spare parts stocked for unsuccessful products. Shortly thereafter, petitioner offered and sold these parts at reduced prices. The Commissioner did not question either of these write-downs (Pet. App. A-36). What is at issue here is the Commissioner's disallowance of petitioner's third claimed inventory reduction of $926,952, representing percentage write-downs of items that petitioner estimated to be in excess of its future needs but which it continued to hold for sale at their original prices.

We submit that both courts below correctly upheld the Commissioner's disallowance of petitioner's third inventory write-down. As we shall now demonstrate, the Commissioner's differentiated treatment of petitioner's three inventory reductions is specifically required by the controlling Treasury Regulations. With respect to the inventory write-down question at issue in this case, these Regulations have been substantially unchanged since their promulgation under essentially identical statutory provisions more than 50 years ago by T.D. 3296, I-1 Cum. Bull. 40 (1922). The Regulations explicitly prohibit reductions of inventory on the basis of estimated changes in value in the absence of objectively determinable standards of actual pricing. Since petitioner continued to hold the inventory items in question for sale at their original prices, its write-downs from cost to net realizable value are barred by the Regulations. As the Tax

Court observed with respect to an analogous inventory reduction claim, "[r]ecognition of the device employed by the petitioner would be clearly violative of the long established rule that the revenue laws only permit the deduction of realized losses and not anticipated losses. *Weiss* v. *Wiener,* 279 U.S. 333; *Lucas* v. *American Code Co.,* 280 U.S. 445. This rule applies with equal effect to those taxpayers properly employing inventories." *Gunderson Bros. Engineering Corp.* v. *Commissioner,* 16 T.C. 118, 129. See also 2 Mertens, *supra,* at §§ 16.25, 16.28.

2. a. The specific authorization for the Treasury Regulations dealing with inventories is Section 471 of the 1954 Code, which has its origin in Section 203 of the Revenue Act of 1918, 40 Stat. 1060.[15] It has

[15] Prior to the enactment of the Revenue Act of 1918, the Secretary had authorized the use of the lower of cost or market method of inventory valuation. See T.D. 2609, 19 Treasury Decisions, Internal Revenue 401 (1917). In recognition of doubts as to his authority in this respect, the Secretary made the earlier decision tentative. T.D. 2649, 20 Treasury Decisions, Internal Revenue 26 (1918). Subsequently, the Attorney General issued an opinion (31 Op. Att'y Gen. 301 (1918)) supporting the Secretary's authority. The Secretary thereupon affirmed T.D. 2609 in T.D. 2744, 20 Treasury Decisions, Internal Revenue 455 (1918). For a description of the operation of the early regulations, see *Willard Mfg. Co.* v. *Kennedy,* 109 F. 2d 83 (C.A. 2).

The Revenue Act of 1918 (approved on February 24, 1919) also contained provisions in Sections 214(a)(12)(a) and 234(a)(14)(a), respectively applicable to individuals and corporations. These provisions were limited in application to the taxable year 1918 and permitted taxpayers to reflect the loss (whether or not realized) or shrinkage in inventory values at the end of 1918 due to oversupply of many items at the end of World War I. See S. Rep. No. 617, 65th Cong., 3d Sess. 8 (1918).

remained essentially unchanged through the enactment of the intervening revenue acts and the Internal Revenue Codes of 1939 and 1954. The statute in 1964 provided:

> Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

As the introductory clause states, the purpose of taking inventories is "in order clearly to determine the income of any taxpayer." Under the statute, accounting rules are simply means to that dominant end. Thus, the question of conformity to "the best accounting practice in the trade or business" is not to be determined by the accounting profession but, "on such basis as the Secretary or his delegate may prescribe * * *," *i.e.,* the Regulations. The courts therefore early recognized that "from the language of the statute itself the basis of the inventories was one peculiarly confided to the commissioner; that to him was left the ascertainment 'of the best accounting practice in the trade or business', * * * a task difficult for the courts and one, which if entered upon by the courts, would, no doubt result in many different bases for inventories * * *." *Riverside Mfg. Co.* v. *United States,* 67 Ct. Cl. 117, 126, certiorari denied, 279 U.S. 863. See

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also *Bedford Mills, Inc.* v. *United States,* 59 F. 2d 263, 269 (Ct. Cl.); *Montreal Mining Co.* v. *Commissioner,* 2 T.C. 688, 694.[16]

Pursuant to this statutory authority, the Commissioner promulgated Treasury Regulations 45 (1920 ed.) (Revenue Act of 1918), Arts. 1581–1588, which, as amended in 1922 by T.D. 3296, I-1 Cum. Bull. 40, have remained substantially unchanged through the numerous reenactments of the basic statute.[17] See *Knapp King-Size Corp.* v. *United States,* 527 F. 2d 1392, 1400 (Ct. Cl.). They currently appear as Treasury Regulations, Sections 1.471–1 through 1.471–8 (26 C.F.R.), of which Sections 1.471–2 and 1.471–4, Appendix, *infra,* pp. 84–88, are of particular relevance here.

b. As the court of appeals correctly observed (Pet. App. A–38 to A–39), both Sections 446 and 471 empower the Commissioner to determine the propriety of a taxpayer's method of accounting in accordance

[16] In several cases, the Tax Court has rejected evidence of trade practices in valuing inventories. See *Brooks-Massey Dodge, Inc.* v. *Commissioner*, 60 T.C. 884, 889; *Estate of Jones* v. *Commissioner*, 20 T.C.M. 26; *Estate of Ginsberg* v. *Commissioner*, 17 T.C.M 472.

[17] See Treasury Regulations 62 (Revenue Act of 1921), Arts. 1581–1588; Treasury Regulations 65 (Revenue Act of 1924), Arts. 1611–1618; Treasury Regulations 69 (Revenue Act of 1926), Arts. 1611–1618; Treasury Regulations 74 (Revenue Act of 1928), Arts. 101–108; Treasury Regulations 77 (Revenue Act of 1932), Arts. 101–108; Treasury Regulations 86 (Revenue Act of 1934), Arts. 22(c)–1 to 22(c)–8; Treasury Regulations 94 (Revenue Act of 1936), Arts. 22(c)–1 to 22 (c)–8; Treasury Regulations 101 (Revenue Act of 1938), Arts. 22(c)–1 to 22(c)–8; Treasury Regulations 103 (1939 Code), Sections 19.22(c)–1 to 19.22(c)–8; Treasury Regulations 111 (1939 Code), Sections 29.22(c)–1 to 29.22(c)–8; Treasury Regulations 118 (1939 Code), Sections 39.22(c)–1 to 39.22(c)–8.

with a "clear reflection of income" standard. Section 446 provides that taxable income shall be determined "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" "[unless] the method used does not clearly reflect income * * *." In that case, "the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." Similarly, Section 471 requires that the Regulations prescribed thereunder conform "as nearly as may be to the best accounting practice in the trade or business *and as most clearly reflecting the income*" (emphasis added). While both provisions make relevant accounting practices, they do not regard that factor as controlling for federal tax purposes if the method does not clearly reflect income.

The statutory language therefore refutes petitioner's claim (Br. 24–31) to accounting autonomy from the requirements of the Regulations on the ground that its inventory valuation procedures conformed to generally accepted commercial accounting practices. All petitioner's reading (Br. 31–34) of the legislative history of Sections 446 and 471 establishes is that conformity to generally accepted accounting practices is a relevant but not controlling factor in determining the propriety of an accounting method for tax purposes under the clear reflection of income standard. To be sure, Section 446(a) and its predecessors since 1918 have required that the taxpayer com-

pute its taxable income in accordance with the method of accounting employed in keeping its books. But this general rule is immediately qualified by the "exception" in Section 446(b), which also originated in the Revenue Act of 1918, that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." The Regulations under Section 446 are to the same effect. While Section 1.446–1(a)(2) provides that a generally accepted method of accounting "will ordinarily be regarded as clearly reflecting income * * *," it also states that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." [18]

Thus, contrary to petitioner's submission, there is no statutory presumption that a generally accepted method of accounting will be regarded as clearly reflecting income if it does not comply with the Regulations. As the court of appeals pointed out (Pet. App. A–39 to A–40), the term "ordinarily" in Section 1.446–1(a)(2) of the Regulations suggests that there can be circumstances in which generally accepted accounting practices do not clearly reflect income. Indeed, to the extent that Congress created a presumption, it is in favor of the Commissioner's judgment that

[18] Moreover, the Regulations also provide that an accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year." Treasury Regulations, Section 1.446–1(c)(ii) (emphasis added).

a method of accounting does not clearly reflect income. That judgment can only be set aside if the taxpayer meets the "heavy burden of proving that the Commissioner's action was plainly arbitrary." *Lucas* v. *Structural Steel Co.,* 281 U.S. 264, 271. As this Court stated in *Brown* v. *Helvering,* 291 U.S. 193, 204–205, "It is not the province of the court to weigh and determine the relative merits of systems of accounting." See also *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *United States* v. *Catto, supra,* 384 U.S. at 114.

3. The current version of the detailed Regulations covers inventories generally (Sections 1.471–1 through 1.471–4), and also, as Section 471 mandates, establishes standards with respect to a number of specific trades or businesses: dealers in securities (Section 1.471–5), livestock raisers and other farmers (Section 1.471–6), miners and manufacturers (Section 1.471–7), and retail merchants (Section 1.471–8). "[I]t is fundamental * * * that as 'contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes' and 'should not be overruled except for weighty reasons.'" *Bingler* v. *Johnson,* 394 U.S. 741, 749–750, quoting from *Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, 501. Accord: *Fulman* v. *United States,* No. 76–1137, decided February 22, 1978, slip op. 5; *United States* v. *Correll,* 389 U.S. 299, 306–307.

This rule of deference is particularly appropriate here since the Regulations in question were issued pursuant to the express statutory authority of

Section 471, and constitute a long-standing administrative interpretation that has been in effect during successive reenactments of the statute. *Helvering* v. *Winmill,* 305 U.S. 79; *Lykes* v. *United States,* 343 U.S. 118. Thus, in upholding the validity of the inventory Regulations in Section 1.471-6(f) with respect to livestock raisers, this Court reaffirmed its earlier decisions holding that "Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers," and that "'It is not the province of the court to weigh and determine the relative merits of systems of accounting.'" *United States* v. *Catto, supra,* 384 U.S. at 114.

We therefore turn to the detailed provisions of the Regulations upon which this case must ultimately turn. Section 1.471-1, Appendix, *infra,* p. 84, establishes the requirement for inventories in enterprises in which the sale of merchandise is an income-producing factor. Section 1.471-2, Appendix, *infra,* pp. 84-86, deals generally with valuation of inventories. Paragraph (a) of that Section reaffirms the statutory requirement that each inventory (1) must conform as nearly as may be to the best accounting practice in the trade or business, and (2) must clearly reflect the income. With respect to accounting practices, Section 1.471-2(c) in turn provides that "The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower." Petitioner, of course, has purported to employ the inventory method of cost or market, whichever is lower.

However, as we shall show, its practice does not conform either to Section 1.471-2, governing inventory valuation generally, or to Section 1.471-4, governing the lower of cost or market method.

Paragraph (b) of Section 1.471-2 acknowledges that inventory rules cannot be uniform but must take trade customs into account, emphasizes the weight given to consistent inventory practice from year to year,[19] and then sets forth the sentence that petitioner argues (Br. 18, 21, 32, 34, 40, 41, 64) controls this case. That sen-

[19] Since inventories are a device employed in an annual accounting system to measure the cost of goods sold, and ultimately income, in each year of a series of years, the consistency requirement of the Regulations makes it necessary that the opening inventory and the closing inventory of each year be valued on the same basis and embody the same assumptions, that the closing inventory of one year be the opening inventory of the next, and that the practice from year to year be consistent. One ground for the Commissioner's disallowance of the write-down here in question was that petitioner's opening and closing inventories for 1964 were not valued on the same basis. The Tax Court (Pet. App. A-25 to A-26) found that nothing occurring in 1964 supported the write-downs at the end of that year but that it was a fair inference from the record that the accumulation of excess inventory occurred over a period of several years. Since petitioner claimed $4 million of inventory write-downs for 1964, as compared with a small fraction of that amount for preceding years, the Tax Court found that its opening inventory for 1964 was valued at a different basis from that of its closing inventory.

This factual finding can serve as an independent basis for disallowance of petitioner's 1964 write-down and affirmance of the decision below even if petitioner's legal position were otherwise sound. As the court of appeals pointed out (Pet. App. A-45), this internal inconsistency in petitioner's accounting rebutted any presumption that might have been created by the sentence in Section 1.471-2 upon which petitioner relies.

Petitioner does not directly challenge the correctness of the Tax Court's finding that its 1964 inventory valuation was inconsistent

tence states: "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income." Petitioner would have this sentence serve as a universal standard that should be read in a vacuum so as to override other specific provisions of the Regulations. But as the court of appeals pointed out (Pet. App. A-39 to A-40), the phrase "'as a general rule'" suggests that there are exceptions and differences applicable to specific situations. Moreover, the immediately preceding sentence of Section 1.471-2(b) states that "greater weight is to be given to consistency * * * *so long as the method or basis used is substantially in accord with §§ 1.471-1 through 1.471-9*" (emphasis supplied). It therefore cannot be argued that the Regulations leave the question whether a particular method meets the clear reflection of income standard to the taxpayer's conformity to accepted commercial accounting practices. For if such were the case, it would virtually render meaningless the detailed provisions of Sections 1.471-1 through 1.471-9 of the Regulations.

4. At all events, whatever persuasive force might be attributed to the "general rule" if it stood alone is rebutted by the specific disapprovals of inventory

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because the excess inventory was accumulated over a period of years. Instead, it argues (Br. 52-53) that any such inconsistency favored the revenues by causing it to have overstated its income for years prior to 1964. But the only year before the Court is 1964. Petitioner cannot invoke alleged overpayments for its prior closed taxable years that are not at issue as a ground for the propriety of its inventory write-downs for 1964.

methods that are set forth in paragraph (f) of the same Section 1.471-2. That paragraph provides as follows:

> (f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:
>
> (1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.
>
> (2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.
>
> (3) Omitting portions of the stock on hand.
>
> (4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.
>
> (5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

Of the five enumerated methods of valuing inventories that are specifically disapproved by the Regulations, the first three, which overlap to some extent, describe the methods by which petitioner wrote down its closing 1964 inventory, or some phase of those methods.

a. *Section 1.471-2(f)(1)*. Subparagraph (1) accurately describes the process by which petitioner reduced its inventory to what it describes as "net realizable value." Anticipating future losses from its inventory of parts that it estimated might prove to be in excess of its needs, and therefore of diminishing value, petitioner's former management in 1960 established a "Reserve for Inventory Valuation," increased this

reserve each year through the first three quarters of 1964 by ten percent of the cost of parts constituting the basis of the reserve, and deducted the increase from its closing inventory at the end of each year. For years prior to 1964, petitioner did not disclose this fact on its income tax returns. The new management that took over in late 1964 employed the same mechanism, but on a much larger scale, and with greatly increased percentage reductions in inventory. Each inventory reduction sought by the reserve mechanism to anticipate future losses and to reduce income for the current year by the amount of those losses estimated to occur in later years.

But the annual accounting requirement upon which our tax system is based does not permit a taxpayer to vault the barrier of the taxable year and deduct losses that may occur in future years. Section 1.471-2(f)(1) implements that fundamental principle and therefore prohibits "[d]educting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof." See 2 Mertens, supra, at § 16.28. Given this explicit prohibition in the Regulations, it is hardly surprising that the courts have rejected such percentage write-downs of inventory, whether the anticipation of diminished realization arose from changes in styles or general price levels, excess supplies, supervening technology, disadvantageous changes in the geographic or business environment, or otherwise.[20] In seeking write-downs based upon estimates

[20] See, *e.g.*, *John L. Ashe, Inc.* v. *Commissioner*, 214 F. 2d 13 (C.A. 5); *Western Dry Goods Co.* v. *United States*, 34 F. 2d 976 (W.D. Wash.); *S & R Chevrolet Co.* v. *Birmingham*, 93 F. Supp. 950, 96-963 (N.D. Iowa); *Brooks-Massey Dodge, Inc.* v. *Commissioner*, 60 T. C. 884; *Pearl* v. *Commissioner*, 36 T.C.M. 1059; *Rogers* v. *Commissioner*, 20 T.C.M. 1515; *Estate of Jones* v. *Commissioner*, 20 T.C.M. 26; *Estate of Ginsberg* v. *Commissioner*, 17 T.C.M. 472; *Kaar* v. *Commissioner*, 16 T.C.M. 355; *Ellstrom* v. *Commissioner*, 14 T.C.M. 312, affirmed *per curiam*, 235 F. 2d 181 (C.A. 6); *Omelian* v. *Commissioner*, 12 T.C.M. 306; *Gem Jewelry Co., Inc.* v. *Commissioner*, 6 T.C.M. 11, 15, affirmed on other issues, 165 F. 2d 991 (C.A. 5), certiorari denied, 334 U.S. 846; *R. J. Darnell, Inc.* v. *Commissioner*, 18 B.T.A. 125, affirmed, 60 F. 2d 82 (C.A. 6); *Boston Oldsmobile Co.* v. *Commissioner*, 16 B.T.A. 114; *Sells Lumber & Mfg. Co.* v. *Commissioner*, 14 B.T.A. 96, affirmed, 41 F. 2d 363 (C.A. 6); *Steiner Tire Co.* v. *Commissioner*, 9 B.T.A. 1289; *Ideal Reversible Hinge Co.* v. *Commissioner*, 7 B.T.A. 1066; *True* v. *Commissioner*, 6 B.T.A. 1042; *Appeal of Adams Motor Co.*, 4 B.T.A. 589, 595; *Appeal of Louis Allen*, 2 B.T.A. 1313; *Appeal of Alexander Reid & Co.*, 2 B.T.A. 425; *Appeal of Orkin Bros.*, 2 B.T.A. 65.

of diminished demand, petitioner would require the Court not only to invalidate Section 1.471-2(f)(1) of the Regulations but also to disapprove a body of case law that extends back even prior to the promulgation of T.D. 3296 in 1922.

b. *Section 1.471-2(f)(2)*. Petitioner wrote down parts of its inventory by 50 percent, by 75 percent, and even by 100 percent, while continuing to offer the items in that inventory for sale at unreduced prices. Such a practice was likewise disapproved by Section 1.471-2(f)(2) of the Regulations. That provision prohibits "[t]aking * * * other parts of the inventory, at a nominal price or at less than its proper value." The soundness of the Commissioner's disapproval in this respect is demonstrated by his allowance of the $245,000 write-down with respect to parts for unsuccessful products that petitioner sold at reduced prices. Petitioner's price reductions and subsequent sale

within a short period of time of these reduced-price items constituted objective evidence that its write-down did not result in a closing inventory figure at less than proper value. But with respect to parts offered and sold at unreduced prices, it is plain that petitioner's greatly reduced inventory prices were " 'nominal' " or " 'less than * * * proper value.' " *Fruehauf Trailer Co.* v. *Commissioner,* 42 T.C. 83, 99, affirmed, 356 F.2d 975 (C.A. 6), certiorari denied, 385 U.S. 822. Petitioner's write-downs are therefore disapproved by Section 1.471-2(f)(2) of the Regulations.

c. *Section 1.471-2(f)(3).* Since petitioner wrote down some of its inventory by 100 percent while retaining the goods in stock and offering them for sale at unreduced prices, its practice was also disapproved by Section 1.471-2(f)(3) of the Regulations. The 100 percent reduction was tantamount to "[o]mitting portions of the stock on hand." When inventory was worthless and was scrapped, the Commissioner permitted a write-down of $2,750,000 since petitioner no longer held those items for sale. But the Regulations prohibit omitting items from inventory by writing them down to zero, while at the same time retaining them and offering them for sale at unreduced prices. To this extent, petitioner's write-downs are barred by Section 1.471-2(f)(3).

The matter is therefore not, as petitioner would have it (Br. 20-21, 23, 61-64), that the Commissioner disapproved its inventory practices because they were not specifically approved by the Regulations. To the

contrary, petitioner's write-downs are specifically disapproved by Section 1.471-2(f)(1)-(3) of the Regulations and by a large body of case law to the same effect.[21]

5. Petitioner further argues (Br. 21, 64, 66-68) that its write-downs of estimated excess inventory are supported by Section 1.471-2(c) of the Regulations. That provision states:

> Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used * * *. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

Both the Tax Court (Pet. App. A-27 to A-28) and the court of appeals (Pet. App. A-42) correctly held this provision to be inapplicable to petitioner's claimed write-down because its excess inventory was not physi-

[21] Petitioner virtually ignores the proscriptions of Section 1.471-2(f) of the Regulations. Indeed, its only reference (Br. 45 n.*) to the provision is to Section 1.471-2(f)(4), one of the two disapproved methods that does not describe petitioner's practice.

cally distinguishable from other units of inventory, *i.e.*, all of its tool parts and accessories were in essentially the same condition, and were commingled and interchangeable. Petitioner therefore failed to carry the burden imposed upon it by the Regulation of proving that its excess parts and accessories were unsalable at normal prices or unusable in the normal way "because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes." See *Cleveland Automobile Co.* v. *United States,* 70 F. 2d 365 (C.A. 6), certiorari denied, 293 U.S. 563; *D. Loveman & Son Export Corp.* v. *Commissioner,* 34 T.C. 776, 799–800, affirmed *per curiam,* 296 F. 2d 732 (C.A. 6), certiorari denied, 369 U.S. 860.

But whether or not the decision below was correct in so holding, Section 1.471–2(c) of the Regulations nevertheless offers no support to petitioner. It permits an inventory write-down only to "bona fide selling prices less direct cost of disposition," and defines the term "bona fide selling price" as an "actual offering of goods during a period ending not later than 30 days after inventory date." Moreover, the Regulation further requires the taxpayer to "maintain such records of the disposition of the goods as will enable a verification of the inventory to be made." Here, petitioner does not dispute (Br. 10, 68) that it did not reduce the offering or sale price of those items of inventory with respect to which the write-downs were disallowed within the 30-day period as required by the Regulations. Indeed, petitioner

never reduced its offering price with respect to such items but continued to hold them for sale at their original prices. There is accordingly no basis in Section 1.471–2(c) for petitioner's claimed write-down from cost to net realizable value. As the court of appeals correctly observed (Pet. App. A–43), petitioner cannot " 'substitute for the actual selling price required by the regulation a suppositious selling price which the Commissioner and the court must accept because it conforms to good accounting practice,' " quoting from *Cleveland Automobile Co.* v. *United States, supra,* 70 F. 2d at 369. Accord: *John L. Ashe, Inc.* v. *Commissioner,* 214 F.2d 13; *Pierce-Arrow Motor Car Co.* v. *United States,* 11 F. Supp. 60 (Ct. Cl.); *D. Loveman & Son Export Corp.* v. *Commissioner, supra; Boston Oldsmobile Co.* v. *Commissioner,* 16 B.T.A. 114; *Appeal of Otto A. Altschul,* 5 B.T.A. 53; *Appeal of Farmers' Hardware Co.,* 2 B.T.A. 90.[22]

[22] *Lucker* v. *United States*, 53 F. 2d 418 (Ct. Cl.), and *Superior Motor Parts Co.* v. *Commissioner*, 8 B.T.A. 407, upon which petitioner relies (Br. 42, 55), are not to the contrary. They each involved obsolete merchandise and are therefore consistent with the Commissioner's action in this case. See *Knowlton Bros.* v. *United States*, 53 F. Supp. 221 (Ct. Cl.) where the taxpayer claimed a stock of merchandise was obsolete, but continued to hold it for sale. In those circumstances, the Court of Claims denied the claimed write-down.

Petitioner's reliance (Br. 42–43) on *Fides Publishers Assn.* v. *United States*, 263 F. Supp. 924 (N.D. Ind.), and *Lord Motor Car Co.* v. *Commissioner*, 5 B.T.A. 818, acq. VI–2 Cum. Bull. 4, is similarly misplaced. In *Fides Publishers Assn.*, the government conceded that the taxpayer was entitled to an inventory write-down based upon future unsalability of some of its volumes in stock. The only question resolved by the court was whether the use of a two-year sales period for the books in question was proper

6. Moreover petitioner's claimed inventory write-down does not come within the terms of Section 1.471-4 of the Regulations which governs "[i]nventories at cost or market, whichever is lower," the method by which petitioner purported to value its inventories. As we have noted (*supra*, p. 32, n. 5), the lower of cost or market method was approved by an Opinion of the Attorney General in 1918, and has been sanctioned by Treasury Regulations since that time. The lower of cost or market method is to some extent a departure from normal rules insofar as it permits a deduction for a loss not yet completely realized. See *Sharp* v. *Commissioner*, 224 F. 2d 920, 924 (C.A. 6); *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144, 148 (C.A. 5). The Regulations, however, strictly confine this departure within objectively determinable standards of actual pricing, and do not leave the determination of market to the imprecise standards applicable to other valuation disputes.

a. Section 1.471-4(a) of the Regulations sets forth the standard for "market" as follows:

> (a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of

(see 263 F. Supp. at 936). However, the court did not address the requirement of Section 1.471-2(c) that the taxpayer prove unsalability by reference to an actual offering of the goods during a period ending not later than 30 days after the inventory date.

In *Lord Motor Car Co.*, the taxpayer proved that the cost of disposition of its used cars was at least 25 percent of their sales price. The court therefore permitted a write-down under the predecessor of Section 1.471-2(c) of the Regulations which is applicable to "second-hand goods taken in exchange."

> the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—
>
> (1) Of goods purchased and on hand, and
>
> (2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; * * *.

As Judge Raum explained in *D. Loveman & Son Export Corp.* v. *Commissioner, supra*, 34 T.C. at 796, "the term 'market,' in the phrase 'lower of cost or market,' means the price which petitioners would have had to pay to replace items in their inventories on the applicable inventory dates. Conversely, it does not mean the price at which such merchandise is resold or offered for resale." Accord: *Pierce-Aroow Motor Car Co.* v. *United States, supra; Elder Mfg. Co.* v. *United States*, 10 F. Supp. 125 (ct. cl.); *Bedford Mills, Inc.* v. *United States, supra.*[23] The correctness of this construction of the term "market" is confirmed by the provision in the Regulations stating that " 'market' means the current *bid price* prevailing at the date of the inventory for the particular merchandise in the volume in which usually *purchased* by the taxpayer * * *" (emphasis supplied).

In other words, the term "market" as used in the Regulations and as uniformly construed by the courts, looks precisely in the opposite direction from petitioner's "net realizable value," by which it estimated the aggregate amount to be realized upon the future sale of its inventory.

[23] Differences between "replacement" and "reproductive" cost are not significant in this case. See 2 Mertens, *supra*, at § 16.22.

The disparity between the Regulations and petitioner's practice is further demonstrated by Section 1.471–4(c) of the Regulations, which requires that each item of inventory under the lower of cost or market method be valued, as opposed to an estimate of the yield of the aggregate. It provides:

> (c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

The decision below properly concluded that petitioner failed to comply with the requirements of this provision of the Regulations. As the Tax Court noted (Pet. App. A–26), petitioner "did not compare the replacement market value of each item with its cost to determine which was lower. Instead, it wrote down the value of the entire inventory applying arbitrary percentages" based upon its estimates of "ultimate salability." But as we have pointed out *supra*, p. 48, such an inventory valuation procedure is entirely within the uncontrolled discretion of the taxpayer and therefore bears no relationship to the objectively verifiable lower of cost or market method specified in the Regulations. The Tax Court therefore correctly concluded: "If we were to approve a concept permitting a write-down of inventory based upon an otherwise unsupported opinion of the taxpayer as to its ultimate salability we would, within some unknown limits, permit the taxpayer to determine how much tax it wanted to pay for a given year" (Pet. App. A–26).

b. Finally, petitioner relies (Br. 64–66) upon Section 1.471–4(b) of the Regulations. That provision addresses two special cases that differ from the "ordinary circumstances" discussed in paragraph (a). The two special cases are (1) "[w]here no open market exists or where quotations are nominal, due to inactive market conditions" and (2) "[w]here the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined." In each instance, recorded prices or offers of sale are to be determinative of market. In the first case, the Regulation requires "such evidence of a fair market price at the date * * * such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith." In the second case, where the taxpayer has offered merchandise at prices lower than current, "the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory."

The court of appeals rejected the applicability of paragraph (b) on the ground that petitioner's excess inventory did not fall within either of the two special cases addressed by that provision. Indeed, petitioner's president conceded that " 'any business which is involved in the manufacture and sale of products inevitably must have excess inventory' " since the cost to produce additional goods that may be needed is marginal and would be prohibitive in the future (Pet. App. A–43 to A–44). But even on the assumption that

the excess inventory takes this case out of the "ordinary circumstances" of paragraph (a), there is nothing in the record that demonstrates the propriety of petitioner's inventory write-downs under Section 1.471–4(b). Rather, the evidence, such as it exists, indicates that the write-downs were improper by the standard of that paragraph. Petitioner may have correctly estimated that its inventory was larger than would be required over a period of time in the future but there was an active and steady market for the parts and products that it did not scrap as obsolete. Moreover, petitioner's percentage write-downs assumed the existence and continuation of such a market for at least a year, since it carried at full value a quantity of each item equal to the preceding year's sales. It therefore cannot be said that no open market existed for petitioner's spare parts. But even if there were an open market for these goods, Section 1.471–4(b) would still not justify the write-downs at issue because petitioner continued to sell the items in its inventory at unreduced prices.

The second case addressed by paragraph (b), where the taxpayer offers the goods at prices less than current, is likewise inapplicable. Furthermore, even if it were applicable, Section 1.471–4(b) makes actual prices and actual offers for sale determinative of "market." The closing sentence of the paragraph reads: "Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market." Here, petitioner acknowledges (Br. 10. 68) that the actual prices at which it sold its parts

and accessories remained unchanged and far above its written-down inventory valuations. Section 1.471–4(b) therefore demonstrates the correctness of the Commissioner's disallowance of its $926,952 reduction of its closing 1964 inventory.

7. Contrary to petitioner's further argument (Br. 38–40), nothing in either *Space Controls, Inc.* v. *Commissioner, supra,* or *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N.D. Ohio), affirmed *per curiam,* 351 F. 2d 449 (C.A. 6), supports its claimed write-downs of inventory it estimated to be in excess of future customer demand.

In *Space Controls,* the taxpayer manufactured military trailers under a government contract. It was stipulated that neither the materials nor the finished trailers were suitable for sale to or use by any one other than the government. After it became apparent that the taxpayer's cost of materials and work-in-process exceeded the price per unit at which it was bound to sell to the government, it wrote down its inventory by the difference under the lower cost or market method.

On these facts, the Fifth Circuit held that the write-down was authorized by Section 1.471–4(b) of the Regulations because the taxpayer's market for the goods was completely restricted and it was contractually bound to sell them to the government at a fixed price. In so holding, the court concluded (322 F. 2d at 151) that the particularized facts of the case fit within the second situation described in Section 1.471–4(b): "'Where the taxpayer in the regular course of business has offered for sale such merchandise at

prices lower than the current price * * *, the inventory may be valued at such prices * * *, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory * * *.' "

Here, however, petitioner's market for its spare parts was not restricted by a fixed price contract nor did petitioner offer such parts for sale at reduced prices. To the contrary, it continued to offer them for sale at their original prices. Thus, unlike the taxpayer in *Space Controls,* petitioner cannot invoke the provisions of Section 1.471-4(b) of the Regulations.

E. W. Bliss Co. is similarly distinguishable. There, the taxpayer manufactured and sold large machinery on a custom basis under fixed price contracts in accordance with orders and specifications furnished by its customers. If the projected cost of a completed machine exceeded a certain percentage of the sale price thereby indicating a decreased profit or a loss, the taxpayer wrote down its inventory to reflect this decrease under the lower of cost or market method. On these facts, the court partially upheld the taxpayer's claimed inventory write-downs with respect to those contracts that were projected to result in a loss (224 F. Supp. at 379, 384).[24] As in *Space Controls,*

[24] The court disallowed the write-downs with respect to those contracts that would not produce a loss on the authority of Section 1.471-4(a)(2) of the Regulations, which excludes from the lower of cost or market method goods in process of manufacture and finished goods on hand "for delivery upon firm sales contracts * * * under which the taxpayer is protected against actual loss * * *." The Regulation specifies that such items must be inventoried at cost.

the court premised its decision on the authority of Section 1.471-4(b) of the Regulations permitting the write-down of inventories under the lower of cost or market method to actual prices "[w]here no open market exists * * *." The court stated: "It is obvious that there can be no open market for a partially finished press built to specifications of a particular purchaser who is bound by a firm contract to accept and pay a stipulated price for the press when completed and delivered" (224 F. Supp. at 379). However, petitioner's spare parts do not meet this description. They were neither subject to fixed price contracts nor built to the specifications of a particular purchaser. Nor were they offered for sale at reduced prices conforming to petitioner's inventory write-downs. Since the decision in *E. W. Bliss Co.* turns upon Section 1.471-4(b) of the Regulations, which is inapplicable in this case (see pp. 51-53, *supra*), it lends no support to petitioner's claimed write-downs.[25]

[25] *Monfort of Colorado, Inc.* v. *United States*, 561 F. 2d 190 (C.A. 10); *Van Pickerill & Sons, Inc.* v. *United States*, 445 F. 2d 918 (C.A. 7); and *C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F. 2d 57 (C.A. 3), upon which petitioner relies (Br. 40-41, 53), are also distinguishable. *Monfort* did not involve a question of inventory valuation but whether a cattle finisher (one who buys cattle and fattens them in feedlots) could include the gains and losses from its hedging operations in the grain and cattle markets in its feed and cattle inventories, rather than reporting them separately.

Van Pickerill likewise did not involve inventory valuation. There, the court held that a liquor distributor's state tax and storage expenses could be currently deducted rather than added to its cost of goods sold and thereby deferred until the liquor was sold. In *C-O-Two Fire Equipment Co.*, it was undisputed that the taxpayer's inventory became obsolete. The sole question was whether it did so in 1946 or 1947.

In sum, the controlling Regulations require that a taxpayer employing the lower of cost or market inventory method must compute "market" value as replacement or reproduction cost unless: (1) the goods are unsalable at normal prices because of damage or obsolescence, (2) no open market exists for the goods, or (3) the taxpayer in the regular course of business has offered such goods for sale at prices lower than cost. In each of the three exceptions, the Regulations provide that the correctness of any inventory write-down from cost will be determined on the basis of either actual offers of sale or sales by the taxpayer that are proximate to the date of the inventory. Here, petitioner has simply written down its inventory of spare parts by $926,952 on the basis of its estimates that the quantities on hand exceed future demand while continuing to hold such parts for sale at their original prices. However, the Regulations explicitly prohibit the reduction of inventories without objective evidence of the accuracy of the taxpayer's valuation. The fact that petitioner continued to hold for sale and sell its spare parts at their original prices objectively demonstrates the impropriety of its write-down.

Petitioner nevertheless complains (Br. 25) that its inability to write down its purportedly excess inventory until it is scrapped or offered for sale at reduced prices leaves it with an "unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost instead of net realizable value, thereby overstating taxable income by such over-

valuation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers" (*ibid.*). But petitioner has exactly the same choice open to every taxpayer owning business property that may have changed in value after acquisition. It may sell, exchange, or otherwise dispose of the property and thereby establish the fact and measure of its gain or loss. Or it may retain the property subject to further market fluctuations and establish the fact and measure of its possibly different gain or loss in some later year. It cannot, as petitioner seeks to do by means of its write-down, have it both ways by claiming a current loss based upon its subjective estimates of value while continuing to hold the property for sale at its original prices.

Indeed, to permit petitioner's claimed inventory write-down would violate the fundamental principle of our income tax system that a deductible loss must be established by a closed and completed transaction, fixed by identifiable events, and not by fluctuations in value. See Treasury Regulations, Section 1.165-1(b). *Boehm* v. *Commissioner,* 326 U.S. 287; *United States* v. *White Dental Co.,* 274 U.S. 398; *Reporter Publishing Co.* v. *Commissioner,* 201 F. 2d 743 (C.A. 10), certiorari denied, 345 U.S. 993. Cf. *Atlanta Biltmore Hotel Corp.* v. *Commissioner,* 349 F. 2d 677, 680-682 (C.A. 5). It may well be that systems of accounting sanctioned or enforced by other bodies, and for other purposes, may require information concerning current or fluctuating values. But those considerations play a carefully restricted role in the income tax pro-

visions of the Internal Revenue Code, and in the accounting systems upon which its administration is based. If the use of "market" in the lower of cost or market method of inventories moves slightly away from the closed transaction rules that predominate in the Internal Revenue Code, the movement is limited and strictly controlled by the Regulations. It does not encompass the uncontrolled accounting autonomy of its own estimates demanded by petitioner, that would, as the Tax Court concluded, "permit [it] to determine how much tax it wanted to pay for a given year" (Pet. App. A-26).

C. THE DECISIONS OF THIS COURT ESTABLISH THAT GENERALLY ACCEPTED COMMERCIAL ACCOUNTING PRACTICES THAT PERMIT RESERVES FOR ESTIMATED FUTURE EXPENSES OR LOSSES ARE NOT CONTROLLING FOR PURPOSES OF COMPUTING THE FEDERAL TAX LIABILITY ON CURRENT INCOME

1. In Section 212(b) of the Revenue Act of 1918, Congress for the first time[26] enacted explicit instructions with respect to the accounting methods of individual taxpayers.[27] The statute provided:

[26] Section 8(g) of the Revenue Act of 1916, 39 Stat. 763, had provided:

"Sec. 8. * * *

"(g) An individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his income as so returned."

Section 13(d) contained a similar provision with respect to corporate taxpayers.

[27] Section 232 made these provisions applicable also to corporations.

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

These provisions have been carried forward through intervening enactments in substantially identical form and now appear as Section 446(a) and (b) of the 1954 Code, Appendix, *infra*, pp. 77-78. In Section 446 (c) of the 1954 Code, Congress enumerated, for the first time, the permissible overall methods of accounting, subject to the provisions of subsections (a) and (b). In 1954, Congress also added Section 446(e), which provides that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the [Commissioner]."

In enacting this provision, the responsible committees explained that "Subsection (e) codifies existing regulations" and that a change in the method of accounting not only includes a change in the general method of accounting, but "also includes a change in the treatment of a material item such as a change in the method of valuing inventory, * * *." H.R. Rep.

No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).

2. If, as we submit, petitioner's write-downs of inventories to its estimates of "net realizable values" conflicts with the provisions of the controlling and long-standing Treasury Regulations, its claim (Br. 28–61) to conformity with generally accepted accounting is of little relevance. An unbroken line of decisions of this Court establishes that generally accepted commercial accounting practices do not govern the computation of federal income tax liability. *Lucas* v. *American Code Co., supra; Lucas* v. *Structural Steel Co., supra; Brown* v. *Helvering, supra,* 291 U.S. at 203–205; *Spring City Co.* v. *Commissioner,* 292 U.S. 182, 189–190; *Bazley* v. *Commissioner,* 331 U.S. 737, 741; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 188–190; *Commissioner* v. *Hansen,* 360 U.S. 446; *American Automobile Assn.* v. *United States,* 367 U.S. 687, 691–693 *Schlude* v. *Commissioner,* 372 U.S. 128; *United States* v. *Catto, supra,* 384 U.S. at 114.

Indeed, even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax liability under the Internal Revenue Code. *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co.* v. *Smith,* 184 F. 2d 422 (C.A. 3), certiorari denied, 340 U.S. 932; *Kansas City Southern R. Co.* v. *Commissioner,* 52 F. 2d 372, 378 (C.A. 8), certiorari denied, 284 U.S. 676. Cf. *Commissioner* v. *Idaho Power Co.,* 418 U.S. 1, 15.

The rationale underlying these authorities rests

upon the differing objectives of the revenue laws and commercial accounting practices. As evidenced by the provisions of Section 446 and its predecessors originating in the Revenue Act of 1918 (*supra,* pp. 58–60), the goal of the revenue laws is to measure net income in accordance with the requirements of an annual accounting system under a clear reflection of income standard. This means that unless specially authorized by statute, a taxpayer cannot currently deduct estimated losses or expenses that it anticipates will arise in the future beyond the close of the taxable year. However, a fair and accurate statement to creditors, shareholders, or prospective investors may take such anticipated losses into account in order to provide a broader and more conservative picture of the company's economic prospects over a period in excess of any one taxable year. See Finney and Miller, *Principles of Accounting, Intermediate* 381–390 (6th ed. 1965). Given the discrete objectives of commercial and tax accounting, the Court has consistently rejected attempts by taxpayers to reduce their taxable income by the use of reserves in anticipation of future losses. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co., supra,* 280 U.S. at 452 (footnote omitted). Accord: *Brown* v. *Helvering, supra,* 291 U.S. at 202.

Here, too, petitioner's accountants may have properly concluded that its $926,952 write-down of purportedly excess inventory was required in order

to project a fair and conservative statement of its financial condition. But petitioner sustained no identifiable loss in the year of the write-down by either scrapping the items in question or offering them for sale at their reduced values. It therefore took no steps to confirm the accuracy of its estimated loss as required by the Regulations. Such an inventory reduction based upon estimates of an anticipated loss is nothing more than a reserve to cover a contingency that may arise in the future. Such a write-down cannot be taken into account in computing current tax liability. As the Court stated in *Weiss* v. *Wiener,* 279 U.S. 333, 335, "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." See also 2 Mertens, supra, §§ 12.67, 12.73.[28]

In this respect, the Court's decision in *American Automobile Assn.* v. *United States, supra,* is particularly instructive as to the subordinate role of generally accepted accounting practices in the computation of income tax liability. There, as here, "the record contain[ed] expert accounting testimony indicating that the [taxpayer's income-deferral method] was in accord with generally accepted accounting principles" (367 U.S. at 691) and the lower court

[28] Here, the inventory write-downs were made by new management with respect to a period governed by old management. Putting tax consideration aside, the inclination of new management in such a situation would be to reduce income for the prior period in order to enhance its own performance.

found this to be the fact (*id.* at 692). But this Court viewed such a finding and the expert testimony upon which it was based as "only to say that in performing the function of business accounting the method employed by the [taxpayer] 'is in accord with generally accepted commercial accounting principles and practices.' It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury" (*id.* at 693; footnote omitted). The Court concluded that while the taxpayer's accounting method "doubtless presents a rather accurate image of the total financial structure," it "fail[ed] to respect the criteria of annual tax accounting and may be rejected by the Commissioner" (*id.* at 692).

Finally, as the Court pointed out in *American Automobile Assn.,* in 1954 Congress briefly adopted provisions that would have permitted deferral of income as well as the deduction of anticipated expenses by the mechanism of reserves that petitioner seeks here. The Senate Finance Committee later explained that the purpose of these provisions (Sections 452 and 462 of the 1954 Code) was to bring "[t]ax accounting * * * more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." S. Rep. No. 372, 84th Cong., 1st Sess. 3 (1955). But the change brought about by Sections 452 and 462 was short-lived, for less than a year later Congress repealed these provisions retroactively. While the taxpayer in *American Automobile Assn.* argued that Congress did not intend by the retro-

active repeal of these provisions to disturb prior law, the Court observed that "the cold fact is that it repealed the only law incontestably permitting the practice upon which the [taxpayer] depends" (367 U.S. at 695). In terms equally appropriate to this case, the Court characterized the retroactive repeal of Sections 452 and 462 as "a mandate from the Congress that petitioner's system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy" (*id.* at 695–696).[29]

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[29] Petitioner attempts (Br. 44–46) to distinguish *American Automobile Assn.* on the ground that the deferral of prepaid income had never been allowed until the enactment of Section 452, which was retroactively repealed, while this case involves Section 471, which has remained unchanged for 50 years. But the clear reflection of income standard of Section 471, which petitioner studiously ignores, has likewise never permitted the establishment of reserves for anticipated inventory losses. However, the enactment of Section 462, which was also retroactively repealed, would have permitted reserves for known future expenses.

On the same day that the Court decided *American Automobile Assn.*, it granted certiorari in *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906, and remanded that case to the court of appeals for reconsideration in the light of *American Automobile Assn.* The court of appeals had allowed a reserve in that case (see 283 F. 2d 279). On remand, the court of appeals reversed its prior decision (see 293 F. 2d 628) and this Court denied certiorari (368 U.S. 976).

In support of its argument that the 1954 Code adopted generally accepted accounting principles as the determinants of taxable income, petitioner (Br. 29–31) cites Austin, Surrey, Warren and Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 Harv. L. Rev. 257 (1954). But this article, which understandably attributed great significance to Sections 452 and 462, was published in December 1954, six months prior to the retroactive repeal of those sections.

In sum, there is no basis for petitioner's contention that its inventory write-downs are entitled to a presumption that they clearly reflected its income because they conformed to generally accepted commercial accounting practices. Both the language of Sections 446 and 471, which has been extant for more than 50 years, and the decisions of this Court establish that the clear reflection of income standard is independent of commercial accounting considerations and that the Commissioner has wide latitude in determining whether a taxpayer's method of accounting clearly reflects its income. Indeed, after the retroactive repeal of Sections 452 and 462, the lower courts have consistently regarded as authoritative this Court's earlier decisions rejecting claimed deductions based upon reserves. See, *e.g.*, *Ertegun* v. *Commissioner*, 531 F. 2d 1156 (C.A. 2); *Portland Copper & Tank Works, Inc.* v. *Commissioner*, 351 F. 2d 460 (C.A. 1); *S. Garber, Inc.* v. *Commissioner*, 51 T.C. 733; *Juniata Farmers Cooperative Assn.* v. *Commissioner*, 43 T.C. 836, 841. If a new rule is to be fashioned, "[t]he validity of the long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case." *American Automobile Assn.* v. *United States*, *supra*, 367 U.S. at 697 (footnote omitted).

D. PETITIONER'S INVENTORY WRITE-DOWN CONSTITUTED A CHANGE OF ACCOUNTING METHOD REQUIRING THE PRIOR CONSENT OF THE COMMISSIONER UNDER SECTION 446(e) OF THE CODE

Even if petitioner's reduction in its 1964 closing inventory were permitted under Section 471 and the

controlling Treasury Regulations, its adoption constituted a change in accounting method which required the prior consent of the Commissioner under Section 446(e) of the Code. It is undisputed that petitioner did not seek and that the Commissioner did not give such consent (A. 22). Although neither the Tax Court nor the court of appeals reached this question (Pet. App. A-30, A-41 n. 12), the decision below that the Commissioner did not abuse his discretion in disallowing petitioner's adjustment to its 1964 closing inventory can be affirmed on this independent ground alone. See, *e.g.*, *Dandridge* v. *Williams*, 397 U.S. 471, 475-476 n. 6; *LeTulle* v. *Scofield*, 308 U.S. 415; *Langnes* v. *Green*, 282 U.S. 531.

Section 446(e) provides that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate." As the Third Circuit explained in *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230, the rationale for requiring the Commissioner's permission prior to implementation of a change of accounting method "is that virtually any material change in the method of reporting income or deduction items will result in a distortion of taxable income, and it is the Commissioner's responsibility to insure that the distortion will not be to the detriment of the Government. The Commissioner accomplishes this by withholding his consent until the taxpayer agrees to adjustments that will prevent, *inter*

alia, duplication of deduction items * * * as a result of the change." Thus, Section 446(e) provides an absolute rule requiring the prior consent of the Commissioner for a change of accounting method. Even if the change results in the clear reflection of income, the taxpayer's failure to secure prior consent for the change can result in disallowance.[30]

Treasury Regulations, Section 1.446-1(a)(1), defines "method of accounting" to include not only the overall method of accounting (*e.g.*, cash basis or accrual basis), but also the "accounting treatment of any item." Moreover, Section 1.446-1(e)(2)(ii)(c) of the Regulations provides: "A change in an overall plan or system of identifying or *valuing items in inventory* is a change in method of accounting. Also *a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting*" (emphasis added). Finally, Section 1.446-1(e)(2)(ii)(a) of the Regulations (Appendix, *infra*, pp. 83-84) defines a material item as "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting in-

[30] The case law and the Regulations (Section 1.446-1(e)(2)(i)) both require that the taxpayer must seek and obtain the permission of the Commissioner prior to instituting a change in its method of accounting even if the method previously used by the taxpayer was erroneous as a matter of law or constituted an impermissible accounting practice. *Witte* v. *Commissioner*, 513 F. 2d 391 (C.A. D.C.); *Commissioner* v. *O. Liquidating Corp.*, *supra*; *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (C.A. 2); *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (C.A. 5).

clude * * * a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder) * * *."[31] Accordingly, a change in the method of computing "market" value of inventory is the treatment of a material item for which the Commissioner's consent must be sought and obtained prior to the institution of the change. *Fruehauf Trailer Co.* v. *Commissioner, supra.*

Here, as the Tax Court found (Pet. App. A–10), petitioner's prior management carried its inventory at its full value, including those portions which the new management viewed to be in excess of anticipated market demand. In 1964, the new management priced the inventory under the prevailing standards and then

[31] The examples in the Regulations illustrating a change in a method of accounting which require the Commissioner's permission prior to implementation include the following (Section 1.446–1(e)(2)(c)(iii)):

"*Example* (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories."

"*Example* (8). A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories."

"began to adjust the inventory valuation, in order to show the inventory at its 'net realizable value,' * * *." (Pet. App. A–36). As the court of appeals stated (Pet. App. A–45), "[T]he new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years." Such a radical shift in inventory valuation is a change of accounting method requiring the prior consent of the Commissioner. It can hardly be doubted that the resulting $926,952 deduction would produce a distortion in taxable income requiring the Commissioner's examination to insure that proper adjustments are made.

Indeed, the record demonstrates that petitioner conceded that the inventory valuation method it adopted in 1964 was a change from the method it previously followed. The notes to petitioner's financial statements prepared for its 1964 annual report expressly acknowledge the changes that had occurred in 1964 (Ex. R, A. 247):

> The Accounts of the company at December 31, 1964 reflect certain changes from the accounting practices and principles previously followed. Changes were made in the methods of determining and valuing obsolete and excess inventory. * * *

In its report to the shareholders, petitioner similarly explained (Ex. P, A. 227): "A portion of the 1964 loss and, to a greater degree, of the extraordinary charge, resulted from changes in accounting practices and principles." Likewise, petitioner's Form 10–K submitted to the Securities and Exchange Commission on April 5, 1965, recognized that (Ex. R, A. 247–

248): "As of December 31, 1964 the company, under new management, revised its methods and procedures with respect to the determination of obsolete and excess quantities of inventories."

The fact that petitioner's expert witnesses testified that, in their opinion, the change in inventory valuation was a change in procedure rather than a change in accounting method and was required for financial accounting purposes is irrelevant in determining whether the Commissioner's permission to institute the change was required under Section 446(e). As we have pointed out *supra*, pp. 67–68, the Regulations and the case law provide that an accounting *procedure* that treats or affects a material item and is a consistently applied accounting practice is a "method of accounting" which requires the permission of the Commissioner in order to be changed. *O. Liquidating Corp., supra*, 292 F. 2d 225; *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (C.A. 2); *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (C.A. 5); *Peoples Bank & Trust Co.* v. *Commissioner*, 415 F. 2d 1341 (C.A. 7). See also *John Wanamaker Philadelphia, Inc.* v. *United States*, 359 F. 2d 437, 441–442 (Ct. Cl.), where the court noted that generally accepted accounting principles are of little help in dealing with the year of the change where the change itself creates a distortion in income.

In sum, petitioner's adoption in 1964 of procedures to write-down its inventory to its "net realizable value" constituted a change in accounting method for which it was required to secure the prior consent of the Commissioner. Cf. *Willard Mfg. Co.* v. *Kennedy*, 109 F. 2d 83. Since petitioner concededly failed to obtain that consent, the Commissioner correctly disallowed its new method resulting in such write-downs.

II

THE COMMISSIONER PROPERLY EXERCISED HIS DISCRETION UNDER SECTION 166(C) OF THE CODE IN DETERMINING THE REASONABLE AMOUNT OF PETITIONER'S BAD DEBT RESERVE ON THE BASIS OF ITS PRIOR EXPERIENCE WITH RESPECT TO THE COLLECTION OF ACCOUNTS RECEIVABLE RATHER THAN ON THE BASIS OF ITS ESTIMATES OF COLLECTIBILITY

Under Section 166(a) of the Code, Appendix, *infra*, p. 77, a taxpayer may deduct each debt that becomes worthless within the taxable year under what is known as the specific charge-off method. Alternatively, an accrual basis taxpayer may elect to use the reserve method of accounting for bad debts authorized in Section 166(c). That subsection provides that "there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts." Under the reserve method, as specific debts become worthless they are deducted from the bad debt reserve. A "reasonable," and thereby deductible, addition to a bad debt reserve is the amount necessary to bring the balance in the reserve account to a level that can be reasonably expected to cover the losses anticipated with respect to debts outstanding at the end of the year. *Dixie Furniture Co.* v. *Commissioner*, 390 F. 2d 139 (C.A. 8).

In providing a limited exception to the general rule that anticipated or estimated losses are not deductible

(*Lucas* v. *American Code Co., supra*), Congress placed the use of the reserve for bad debts entirely within the discretion of the Commissioner. *Massachusetts Business Development Corp.* v. *Commissioner,* 52 T.C. 946, 951. Accordingly, it is well established that a determination by the Commissioner that a taxpayer's additions to its reserve are excessive must be upheld unless the taxpayer can establish that the Commissioner abused his discretion in reducing the claimed deductions. *Malone & Hyde, Inc.* v. *United States,* 568 F. 2d 474, 477 (C.A. 6); *First National Bank of Chicago* v. *Commissioner,* 546 F. 2d 759, 761 (C.A. 7); *Atlantic Discount Co.* v. *United States,* 473 F. 2d 412 (C.A. 5); *United States* v. *Haskel Engineering & Supply Co.,* 380 F. 2d 786, 789 (C.A. 9); *Paramount Finance Co.* v. *United States,* 304 F. 2d 460, 464 (Ct. Cl.).

Here, at the close of 1965, petitioner estimated the collectibility of each of its accounts. It set aside a 100 percent reserve for accounts it considered to be wholly uncollectible. It also applied the dollar ratio of uncollectible accounts to the total amount of accounts of more than $100 and applied this fraction to 90-day old accounts with a balance of less than $100. Moreover, petitioner established a flat two percent reserve for all other 90-day accounts and all accounts between 30 and 90 days past due. Finally, petitioner established a one percent reserve for all accounts less than 30 days old (Pet. App. A-47). These computations resulted in a total addition to petitioner's bad debt reserve of $135,150 (Pet. App. A-48).

Pursuant to his authority under Section 166(c), the Commissioner recomputed petitioner's bad debt reserve by applying the formula approved in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula measures the current addition to the bad debt reserve on the basis of the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). The *Black Motor Co.* formula yielded an addition to petitioner's bad debt reserve of $74,790.80 (Pet. App. A-48).

Petitioner challenges (Br. 74-76) the Commissioner's use of the *Black Motor* formula, asserting that its method of estimating the current collection potential of each class of accounts in accordance with their age is more accurate. However, the courts have consistently approved the *Black Motor Co.* formula as a "reasonable" method of computing a reserve for bad debts. See, *e.g., Atlantic Discount Co., Inc.* v. *United States, supra; Ehlen* v. *United States,* 323 F. 2d 535, 540 (Ct. Cl.); *S. W. Coe & Co.* v. *Dallman,* 216 F. 2d 566 (C.A. 7).

Moreover, petitioner did not come forward with any evidence that established that the Commissioner's use of the *Black Motor Co.* formula was an abuse of discretion. Petitioner introduced one exhibit (Ex. 18, A. 222) that simply showed how it computed its bad debt reserve and its accountants testified that its method was the preferred accounting practice. But the fact that a taxpayer's method of computing its

bad debt reserve is the preferred accounting practice does not establish an abuse of discretion by the Commissioner. *United States* v. *Haskel Engineering & Supply Co., supra; Calavo, Inc.* v. *Commissioner,* 304 F. 2d 650, 655 (C.A. 9). Petitioner did not show that conditions at the end of 1965 would make collection of accounts receivable less likely than in prior years.[32] Indeed, the Tax Court concluded from the entire record that collectibility was probably more likely at the end of 1965 than in prior years because of the advent of new management (Pet. App. A–32).[33] In short, petitioner did not prove that the Commissioner's method of determining its allowable bad debt reserve was in fact unreasonable.[34]

Rhode Island Hospital Trust Co. v. *Commissioner,* 29 F. 2d 339 (C.A. 1); *Calavo, Inc.* v. *Commissioner, supra;* and *Travis* v. *Commissioner,* 406 F. 2d 987 (C.A. 6), upon which petitioner relies (Br. 77–78),

[32] *Westchester Development Co.* v. *Commissioner*, 63 T.C. 198, acq. 1975–2 Cum. Bull. 2, upon which petitioner relies (Br. 75, 79), is therefore distinguishable. There, the Commissioner improperly included in the base period taxable years after the year in issue. Moreover, the taxpayer in that case showed that the base period was a "wholly unrepresentative period" in its history (63 T.C. at 212). Under these circumstances, the Tax Court held that the Commissioner had abused his discretion.

[33] From the end of 1964 to the end of 1965, petitioner's accounts receivable declined by approximately $1.4 million. However, its claimed bad debt reserve increased by $55,000 (Ex. Q, A. 239).

[34] Petitioner asserts (Br. 80) that during 1960–1963 its accounts receivable increased by 26.1 percent but that the chargeoffs by prior management decreased from 10 percent to 0.8 percent of the receivables. But such facts do not demonstrate that the six-year period ending at the close of 1965 was unrepresentative of petitioner's experience or that collectibility at the end of 1965 was less likely than in prior years.

are not to the contrary. In each of those cases, the courts reaffirmed the Commissioner's statutory discretion with respect to bad debt reserves. However, the taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve failed to consider all the facts and circumstances and thus constituted an abuse of discretion.[35] Here, on the other hand, petitioner failed to make that showing. On this record, the court of appeals therefore correctly concluded that "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (Pet. App. A–48).[36]

[35] In *Rhode Island Hospital Trust Co.*, the court found that "unusual conditions" were present during the taxable year justifying the addition of $200,000 to the reserve and remanded the case to the Tax Court to test the reasonableness of another addition of $87,500, which had not been properly considered by the Commissioner. In *Travis*, the court found the Commissioner's determination "clearly erroneous" on the facts presented, which included a stipulation that the $31,618.22 in dispute was not collected, showing that there were particular collection problems with the dance studio contracts involved. In *Calavo, Inc.*, the Ninth Circuit held that the Commissioner had erroneously disregarded certain known factors affecting the collectibility of a specific debt and remanded the case to the Tax Court so that the Commissioner could give proper consideration to the particular circumstances in question.

[36] Petitioner's method of estimating uncollectible accounts receivable based on the length of time a debt has been outstanding is a technique commonly referred to as the "aging of receivables" (A. 120, 141, 167, 184–185). See Finney and Miller, *supra*, at 176. While use of the aging method gives an accurate portrayal of the estimated realizable value of the total accounts receivable for balance sheet purposes, it may fail to distribute losses to the proper periods. *Id.* at 176–177. See also *United States* v. *Haskel Engineering & Supply Co., supra*, where the court upheld the Commissioner's determination based on experience against the taxpayer's determination based on the "aging" method.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly Worthless Debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially Worthless Debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * * *

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the

basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer Engaged in More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

Sec. 471. General Rule for Inventories.

Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.166-4 *Reserve for bad debts.*

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve.*

(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.* A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

* * * * *

§ 1.446–1. *General rule for methods of accounting.*

(a) *General rule.*

(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all

method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or busi-

ness will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

* * * * *

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

* * * * *

(b) *Exceptions.*

(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

* * * * *

(e) *Requirement respecting the adoption or change of accounting method.*

* * * * *

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent

treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451–3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change. [As amended by T.D. 7073, 1970–2 Cum. Bull. 98 (November 18, 1970), effective for taxable years beginning after December 31, 1953.]

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§ 1.471–1. *Need for inventories.*

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases,

whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

§ 1.471–2. *Valuation of inventories.*

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471–1 through 1.471–9. An inventory that can be used under the best accounting practice in a balance sheet showing the finan-

cial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

* * * * *

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

§ 1.471–4. *Inventories at cost or market, whichever is lower.*

(a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

(b) Where no open market exists or where quotations are nominal, due to inactive market

conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article. * * *

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